No. 75-1312

In the Supreme Court of the United States

OCTOBER TERM, 1975

DON E. WILLIAMS CO., PETITIONER

v.

COMMISSIONER OF INTERNAL REVENUE

ON PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE SEVENTH CIRCUIT

MEMORANDUM FOR THE RESPONDENT

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The question presented in this federal income tax case is whether petitioner's accrual of a liability to the trustees of its employees' profit-sharing plan prior to the close of its taxable year and its delivery of its promissory note to the trustees during the first months of the following taxable year was a "payment" to the plan within the meaning of Section 404(a) of the Internal Revenue Code of 1954, so as to entitle petitioner to an income tax deduction in the face amount of the note for the year in which the liability was accrued. Both the Tax Court (62 T.C. 166) and the court of appeals (527 F.2d 649) held that petitioner's delivery of its note was not a "payment" under the statute.

The pertinent facts are as follows: Petitioner is a corporation that maintains its books and records and files its income tax returns on the accrual method of accounting. Since 1964, petitioner has had a profit-sharing plan for its employees, which was qualified under Section 401(a) of the Code. The trustees of the plan were the principal shareholders and officers of petitioner, Don E.

Williams, Jr., Joseph W. Phillips, Jr., Alice R. Williams, and the First National Bank of Moline (Pet. App. A 2a; Stip., pars. 8, 9).[1]

In the final days of its taxable years ending April 30, 1967, 1968, and 1969, petitioner's board of directors authorized contributions to its profit-sharing plan of $31,589.32, $34,333.26, and $35,337.86, respectively. Petitioner accrued these amounts as liabilities on its books at the close of each taxable year (Pet. App. A 3a; Stip., pars. 11-27).

During the month immediately following the accrual of these liabilities to the profit-sharing plan, petitioner delivered to the trustees of the plan its interest-bearing promissory notes payable on demand in the face amounts of the accrued liabilities. The notes issued in 1967 and 1968 bore interest at 6 percent and the 1969 note bore interest at 8 percent. The notes were guaranteed by the officers and principal shareholders of petitioner and secured by collateral consisting of stock of petitioner and the interests of two of the shareholders in the profit-sharing plan. It was stipulated that the value of the collateral plus the net worth of one of the guarantors exceeded the face amount of each note (Pet. App. A 3a; Pet. App. B 14a).

On April 4, 1968, petitioner delivered its check for $33,353.03 to the trustees of its profit-sharing plan in payment of its May 26, 1967, promissory note of $31,589.32 plus accrued interest of $1,763.71. On April 28, 1969, petitioner delivered its check for $36,381.81 to the trustees in payment of its May 24, 1968 note of $34,333.26 plus accrued interest of $2,048.55. Finally, on March 31, 1970, petitioner delivered its check for $37,929.21 to the trustees in payment of its May 30, 1969 note of $35,337.86 plus $2,591.45 of accrued interest (Pet. App. A 3a; Stip., pars. 11-27).

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[1]"Stip." refers to the stipulation set forth at pages 6-13 of petitioner's brief filed in the court of appeals.

On audit, the Commissioner of Internal Revenue determined that petitioner's delivery of its demand promissory notes to the trustee of its profit-sharing plan did not constitute "payment" to the plan within the meaning of Section 404(a) of the Code. He accordingly disallowed petitioner's claimed deductions for the year in which it accrued the liabilities in the face amounts of the notes and allowed deductions for those years only to the extent of petitioner's actual payments to the plan (Pet. App. A 2a). In a reviewed decision with three dissents, the Tax Court upheld the Commissioner's position that the requirement of "payment" of Section 404(a) of the Code is not satisfied by the delivery of promissory notes (Pet. App. A 1a-12a). The court of appeals unanimously affirmed (Pet. App. B 13a-20a).

1. Section 404(a) of the Code provides that "[i]f contributions are paid by an employer to * * * a * * * profit-sharing * * * plan," the contributions shall be deductible "[i]n the taxable year when paid * * * ." Section 404(a)(6) establishes a special rule for accrual basis taxpayers who make such contributions. It states that "a taxpayer on the accrual basis shall be deemed to have made a payment on the last day of the year of accrual if the payment is on account of such taxable year and is made not later than the time prescribed by law for filing the return for such taxable year (including extensions thereof)."

Here, petitioner, an accrual basis taxpayer, delivered its promissory notes to its profit-sharing plan after the close of its taxable year but prior to the time it was required to file its return for that year.[2] If petitioner

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[2]Pursuant to Section 6072(b) of the Code, a corporation is required to file its income tax return on or before two and one-half months after the close of its taxable year. Since petitioner's

had paid its accrued liabilities to the plan at the times it delivered its promissory notes to the trustees, it would have come within the special rule of Section 404(a)(6) that enables accrual basis taxpayers to deduct such contributions for the preceding taxable year as long as they are paid prior to the filing of its return for that year. But petitioner did not "pay" the amount of the accrued liabilities; it delivered its note which it did not pay until after it filed its returns for the years in which it accrued the corresponding liabilities and claimed deductions. Under these circumstances, the courts below correctly held that the delivery of notes was not a "payment" within the meaning of Section 404(a) of the Code.

2. The pertinent legislative history confirms that the payment requirement of Section 404(a) is not met by the delivery of a promissory note. In describing the predecessor[3] of the accrual basis rule now set forth in Section 404(a)(6), the House Committee Report observed: "An employer on the accrual basis of accounting may under existing law deduct contributions *actually paid* within the first 60 days of the subsequent year" H.R. Rep. No. 2087, 80th Cong., 2d Sess., p. 13 (1948) (emphasis supplied). Moreover, in extending the 60-day period to two months and 15 days at the time of the 1954 codification, Congress reaffirmed the "actual payment" requirement. See S. Rep. No. 1622, 83d Cong., 2d Sess., p. 55 (1954). In light of these clear statements of legislative intent, the court of appeals correctly interpreted the congressional reference to "actually paid" to "connote a liquid form of payment and not a promissory note which is in substance only another form of an obligation to pay" (Pet. App. B 17a).

taxable year ended April 30, it could have made a "payment" under Section 404(a)(6) on or before July 15 that would have been deductible for the preceding taxable year.

[3]The statutory predecessor of Section 404(a)(6) of the current Code is Section 23(p)(1)(E) of the 1939 Code. The 60-day grace period was extended to two months and 15 days by Section 404(a)(6) of the 1954 Code. See H.R. Rep. No. 1337, 83d Cong., 2d Sess., p. A151 (1954); S. Rep. No. 1622, 83d Cong., 2d Sess., pp. 55, 292 (1954). The House had first recommended this extension in 1948. See H.R. Rep. No. 2087, 80th Cong., 2d Sess., p. 13 (1948).

Treasury Regulations (26 C.F.R.), Section 1.404(a)-1(c), similarly provides that an accrual basis taxpayer may deduct an accrued contribution to a profit-sharing plan for the year of accrual "provided payment is actually made not later than the time prescribed by law for filing the return for the taxable year of accrual * * *."

Thus, apart from the two and one-half month grace period applicable to accrual basis taxpayers such as petitioner, Section 404(a) puts cash and accrual basis taxpayers on the same footing. Both must make actual payment to a profit-sharing plan to be eligible for the deduction.

Petitioner does not deny that Section 404(a) requires more than an accrual of the liability to the profit-sharing plan.[4] The only question therefore is what constitutes "actual payment" under the statute. Since the statute requires both cash basis and accrual basis taxpayers to make actual payment as a prerequisite for the deduction, petitioner is subject to the same rule applicable to a cash basis taxpayer. As the court of appeals correctly recognized (Pet. App. B 15a-16a), the decisions of this Court have

[4]When Congress intended to permit accrual basis taxpayers to deduct accrued but unpaid items, it has employed the term "paid or incurred" or "paid or accrued." See Sections 162(a) (business expenses), 163(a) (interest), and 164(a) (taxes).

long held that the giving of a promissory note by a cash basis taxpayer does not constitute "actual payment" for federal tax purposes.

In *Eckert* v. *Burnet*, 283 U.S. 140, the Court held that the endorser of the note of an insolvent maker could not claim a bad debt deduction upon taking up the note and substituting one of his own notes to the creditor. There, the Court stated, in quoting from the opinion of the Board of Tax Appeals with approval, that the taxpayer "merely exchanged his note under which he was primarily liable for the corporation's notes under which he was secondarily liable, without any outlay of cash or property having a cash value" (283 U.S. at 141; 17 B.T.A. at 266).

Similarly, in *Helvering* v. *Price*, 309 U.S. 409, the Court on the authority of *Eckert* rejected the argument, advanced by petitioner in the courts below, that the delivery of a secured note in satisfaction of an obligation gave rise to a tax deduction. In the Court's view, "if [the] promise to pay was not sufficient to warrant the deduction until the promise was made good by actual payment, the giving of security for performance did not transform the promise into the payment required to constitute a deductible loss in the taxable year" (309 U.S. at 414). Here, too, petitioner's giving of a note does not entitle it to a deduction because "[i]f the note is never paid, [it] has parted with nothing more than [its] promise to pay." *Hart* v. *Commissioner*, 54 F.2d 848, 852 (C.C.A. 1).[5]

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[5]The lower courts have applied the principle established in *Eckert* and *Price* in denying a variety of claimed deductions. See, *e.g.*, *Cleaver* v. *Commissioner*, 158 F.2d 342 (C.C.A. 7) (giving of note is not interest "paid" for purpose of the interest deduction); *Jenkins* v. *Bitgood*, 101 F.2d 17 (C.C.A. 2) (giving of note is not actual payment for purposes of the loss deduction); *Baltimore Dairy Lunch* v. *United States*, 231 F.2d 870, 875 (C.A. 8) (same).

3. Although the Tax Court has consistently upheld the Commissioner's position that the delivery of a note is not "payment" within the meaning of Section 404(a),[6] three courts of appeals have treated the contribution of promissory notes to profit-sharing plans as "payment" under Section 404(a) or its substantially identical predecessor, Section 23(p) of the 1939 Code. See *Sachs* v. *Commissioner*, 208 F.2d 313 (C.A. 3) (demand promissory note payable at a bank); *Time Oil Co.* v. *Commissioner*, 258 F.2d 237 (C.A. 9) (non-interest bearing demand promissory note); and *Wasatch Chemical Co.* v. *Commissioner*, 313 F.2d 843 (C.A. 10) (five-year unsecured promissory note). In the view of those courts of appeals, the delivery of a demand note is equivalent to the giving of a check. However, unlike a check which is an order to a bank to pay money as directed, a note is only a promise to pay, the delivery of which is not actual payment. These decisions are, as petitioner asserts (Pet. 8-11) and the court of appeals acknowledged (Pet. App. B 17a-19a), in conflict with the decision in this case. Moreover, the Internal Revenue Service advises that there are 116 cases pending administratively involving the issue with $3,675,000 of taxes at stake.[7]

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[6]See *Logan Engineering Co.* v. *Commissioner*, 12 T.C. 860; *Freer Motor Transfer* v. *Commissioner*, 8 T.C.M. 507; *Slaymaker Lock Co.* v. *Commissioner*, 18 T.C. 1001, reversed *sub nom. Sachs* v. *Commissioner*, 208 F.2d 313 (C.A. 3); *Time Oil Co.* v. *Commissioner*, 26 T.C. 1061, reversed, 258 F.2d 237 (C.A. 9); *Wasatch Chemical Co.* v. *Commissioner*, 37 T.C. 817, reversed, 313 F.2d 843 (C.A. 10).

[7]The issue is also pending in the following cases: *Coastal Electric Corp.* v. *Commissioner*, 34 T.C.M. 1007, appeal pending, C.A. 4, No. 75-2184; *Lancer Clothing Corp.* v. *Commissioner*, 34 T.C.M. 776, appeal pending, C.A. 2, No. 76-4012; *Patmon, Young & Kirk Professional Corp.* v. *Commissioner*, 34 T.C.M. 798, appeal pending, C.A. 6, No. 75-2214.

Accordingly, we do not oppose the granting of the petition for a writ of certiorari.

Respectfully submitted.

ROBERT H. BORK,
Solicitor General.

MAY 1976.

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